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The Honorable Michael T. McRaith
Director, Federal Insurance Office
Department of Treasury
1500 Pennsylvania Avenue, NW.
Washington, DC 20220.
VIA REGULATIONS.GOV

Re: Comments on Study describing the breadth and scope of the global reinsurance market and the critical role such market plays in supporting insurance in the United States

Docket number: 2012-15685

August 21, 2012

Dear Director McRaith:

R Street is a newly established public policy think tank devoted to free markets; limited, effective government; and responsible environmental stewardship.

Operating from offices in Washington, D.C.; Columbus, Ohio; Austin, Texas; and Tallahassee, Fla, R Street aims to advance free markets in a pragmatic, common sense fashion. R Street's founding staff members all previously worked for the Heartland Institute and, under the R Street banner, continue research and outreach in a wide variety of insurance-related fields.

R Street is an independent non-profit, non-partisan, free-market think tank. Insofar as R Street looks to thinkers like John Stuart Mill, Friedrich Hayek, Milton Friedman and James C. Scott as guides to good public policy, it might fairly be described as part of the political right. At the same time, R Street is concerned—passionately—with making sure government does its work in an efficient, effective manner. Above all, R Street is much more interested in solving problems and working with others than in winning political fights.

In this context, R Street is pleased for the opportunity to comment on the critical role the global reinsurance market plays in supporting the United States' insurance market. Our comments, which follow, touch on three of the six particular areas of inquiry listed:

1. The purpose of reinsurance;

5. The role and impact of government reinsurance programs

6. The coordination of reinsurance supervision nationally and internationally.

Our comments strive to highlight specific points related to our work to date, rather than provide an encyclopedic review of the topics we address. Our particular comments follow:

<u>The Purpose of Reinsurance</u>

Others will likely answer that the reinsurance market's purpose is to transfer risk between insurers; stabilize insurance markets overall; provide excess capital; and facilitate smoother and more predictable earnings for insurers and reinsurers alike. Reinsurance, indeed, does all of these things and all of them are important.

But reinsurance is also the fundamental mechanism by which human civilization manages very large collective risks. In order for people to develop certain areas, use certain technologies and deal staggeringly complex global economic conditions, a mechanism is need to manage the risks that are too large for any single firm to grasp intellectually or underwrite mathematically. Even if a single firm could get a handle on such problems, it almost certainly could not diversify its risk broadly enough to stay in business following a major catastrophe. By spreading the risk throughout the world, reinsurance provides for global coverage—and global management—of society's most challenging and complex risks.

<u>The Role and Impact of Government Reinsurance Programs</u>

National and state governments are intrinsically ill-suited to playing a role in property and casualty reinsurance. Although frequently packaged, presented and sold as reducing rates for consumers or stabilizing insurance markets broadly, government-run reinsurance programs tend to do just the opposite.

Although they do not function perfectly, global reinsurance markets distribute risks broadly across international borders, thus allowing the risks of hurricanes in Florida to be grouped with the risks of cyclones in Australia, industrial accidents in Japan and flooding in the United Kingdom. All other things being equal, an insurer offering coverage over a broader, more diversified pool of risks will be able to offer lower prices to consumers while still making a similar or greater level of profit. It can do this because, with a broader risk pool, it can offset the risk load required for a particular class of risks with underwriting profits from coverage of other, uncorrelated risks.

This is not how government-run reinsurers tend to operate. Instead, they consolidate risk within the borders of one country or even one political subdivision. Given that the majority share of U.S. reinsurance ultimately goes to foreign reinsurers[1], switching to a governmental solution would entirely upend the framework which current insurance and reinsurance markets operate. Evidence demonstrates this shift will not be effective. In making recommendations regarding government-run reinsurance, we urge the office should keep the following things in mind:

Government is not *necessarily* incompetent, slow-moving or bureaucratic (although it often is all of these things) but it is hampered in its ability to diversify risk on a global scale. To simply break even in the long run, a government-run reinsurer would have to both diversify its underwriting exposure and invest its capital in a manner that produces returns similar to those that private companies can earn. To do that would leave taxpayers on the hook for disasters in other parts of the world *and* for any unsatisfactory investment returns. It would literally be a matter of taking very large gambles with taxpayer money. And it's unlikely to work. To underline this, we'd make a number of associated points.

The nation's one large government-run reinsurer currently is a dismal failure that, by its own accounting, will be unable to pay likely claims.

Although a variety of government-run entities – including state residual automobile insurance markets in North Carolina and Rhode Island, the Federal Crop Insurance Corp., the nuclear liability pool established under the Price-Anderson Nuclear Industries Indemnity Act, and the Terrorism Risk Insurance Program – have certain points of similarity with reinsurance offered in the private market, all of them have enormous differences. Price-Anderson and TRIA, for example, have never been triggered. The state-run automobile reinsurance facilities, likewise, are a different way of structuring shared or residual automobile insurance markets that exist, at least in statute, in all 50 states.[2] Federal crop insurance, likewise, does not follow the rules of reinsurance insofar as the program, at the end of the day, simply bills the Treasury (which, itself, does no underwriting of crop risk) what would otherwise be economic losses.

The best working example of a government-run reinsurer in the United States, then, is the Florida Hurricane Catastrophe Fund. Since 1993, the Cat Fund, as it is popularly known has required its reinsurance be purchased by all admitted market property insurers in

[1] Towers Watson, "State of the Reinsurance Market: Practical Perspectives on Property Reinsurance/Reinsurers," 2010, http://www.casact.org/education/annual/2010/handouts/C28-State.pdf

[2] See e.g. Eli Lehrer. "North Carolina's Auto Insurance System: Still Unfair, Still in Need of Improvements," The John Locke Foundation, 2011, http://www.scribd.com/doc/54061244/North-Carolina-s-Auto-Insurance-System-Still-Unfair-Still-in-Need-of-Improvements

Florida.[3] The fund has been expanded several times, most prominently and significantly in 2007. Florida law essentially requires insurers to treat coverage from the Cat Fund as equivalent to private coverage. The results have not been good for the state. By its own account, the Cat Fund simply cannot pay all claims that it could potentially receive.

For 2012, the Cat Fund's financial advisors estimate the fund's obligations for its mandatory coverage are $17.0 billion, plus an addition $317 million in obligations for the optional "temporary increasing in coverage" layer, or TICL. Barring a significant catastrophe, the fund's year-end balance is $8.56 billion, leaving it with $8.757 billion that would need to be borrowed to make good on its obligations. If completed all at once, that would top the largest all-at-one-time municipal bond issuance in history, the $6.543 billion issued by the State of California in 2009. Even if broken up into smaller issuances over the course of a year, major underwriters estimate the Cat Fund could only borrow about $7 billion, which would leave it with a $1.76 billion shortfall.[4]

Even if the fund's obligations were fully covered, any bond issuance require assessments that could, according to the state's own Office of Insurance Regulation, drive roughly half of the state's insurers into receivership. This is against a background that has seen the number of insurers in the state fall by roughly 50 percent since the mid-1990s.

Rather than serving as a force to stabilize the state's insurance and reinsurance markets, therefore, the Florida Hurricane Catastrophe fund—through the risks it imposes on the state—serves to destabilize the market and introduce new uncertainties. Its own management and the state's chief insurance regulator both support reform of the Cat Fund that would shrink its size and scope. Quite simply, the Cat Fund has not worked.

Federal Reinsurance programs cannot work as advertised; the one proposal currently before Congress to create a federal reinsurance program is fatally flawed.

The fact that the nation's one government-run reinsurer has not worked as intended does not, by itself, indicate that no such program ever could. However, it is also safe to say that the major bill to create a federally run reinsurer—a bond guarantee mechanism intended to backstop the privately run, publicly funded California Earthquake Authority—would not work as advertised.[5] A study commissioned by R Street and performed by Lawrence Powell of the University of Arkansas reaches conclusions that are damning the proposal.[6] The findings can be summarized as follows:

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3 Florida Hurricane Catastrophe Fund. "About," http://www.sbafla.com/fhcf/AbouttheFHCF/tabid/278/Default.aspx

4 Raymond James & Associates. *Report Prepared for the Florida Hurricane Catastrophe Fund: Claims-Paying*, May 10, 2012, http://www.sbafla.com/fhcf/LinkClick.aspx?fileticket=8-4VSlmHlFE%3d&tabid=318&mid=1005

6 Lawrence Powell. "Analysis of S. 637, The Earthquake Insurance Affordability Act," R Street Policy Study No. 3, August 2012, http://rstreet.org/policy-study/analysis-of-s-627-the-earthquake-insurance-affordability-act/

> While proponents of the bill project it would produce a 33 percent reduction in premiums and an 85 percent increase in policyholder take-up, this study concludes a best case scenario of an 8 percent decrease in the cost of CEA coverage and a 3.5 percent increase in take-up. In addition, S.637 would shift the cost of California earthquake risk forward in time; increasing post-loss premiums to pay for pre-loss discounts. Finally, the assumed cost neutrality to the U.S. Treasury takes as given that Treasury will charge adequate, risk-based premiums to the CEA for providing a guarantee of post-event capital. Other federal risk transfer programs have made similar promises, but S. 637 would be unique if it actually achieved such an outcome. [7]

Other proposals to, variously, provide windstorm insurance through the National Flood Insurance Program, set up a federal reinsurance backstop to certain state property insurance programs and otherwise get the federal government into the reinsurance business appear extremely likely to have similarly high costs to taxpayers without corresponding benefits to the country as a whole.[8]

Under very limited circumstances, government reinsurance may nonetheless be better than the alternatives

Despite all of the above and the inherent flaws of any government run-reinsurance system, it is theoretically possible that such systems may be necessary under extremely unusual circumstances. In particular, we would suggest a three-part test to determine if the government should *ever* act as a reinsurer. We'd suggest that federal and state governments consider these three tests in deciding that government reinsurance has a role and make sure that any reinsurance program administered by the government meet these criteria:

1) **There is a strong and long-lived historical precedent that the government uses tax money to pay for the expense to be reinsured.**

With some very narrow exceptions, the federal government has not provided significant funds to rebuild private homes following disasters or cover the first dollar of agricultural losses. On the other hand, it has always provided money to local communities with funds after terrorist attacks and assisted with the rebuilding of public infrastructure. The fact that something has been a public function does not necessarily mean it is uninsurable (infrastructure repairs surely *can be* insured) but it does mean that states and localities impacted by such a disaster almost certainly will not buy insurance, since they can reasonably assume that the federal government will pick up a portion of their costs. This is a legitimate reliance interest that should be taken into account in public policy-making. The existence of such an interest does not, by itself, mean that the government should continue to act as it did in the past. It does, however, mean that government programs

[7] ibid.

[8] See e.g. "Study Finds Economic Cost of Cat Legislation Burdensome," in *Claims Journal,* August 22, 2008, http://www.claimsjournal.com/news/national/2008/08/22/93015.htm

with certain required industry-wide retentions and individual deductibles might actually serve to minimize actual liabilities placed on the public sector.

2) **The expense to be reinsured will not be covered by the private sector by ordinary means.**

If private coverage for the expense exists in a market with an ordinary structure for the type of coverage that is being sold--typically, in other words, the "admitted" insurance market—then government should not intervene. This doesn't necessarily have to mean that there is no coverage *at all* (an excess and surplus lines carrier or Lloyds' syndicate will always write some coverage) but rather, that it's not available by ordinary means. The fact that many people find private coverage a poor value, too expensive, or simply elect not to purchase it does not, by itself, mean that the private sector does not write the coverage. For example, although many people are dissatisfied with the homeowners' insurance coverage available in Florida, there is little doubt that the private sector can and does provide such coverage. Indeed, most of Florida's wind insurance is private. Likewise, a low take-up rate for certain coverage that experts believe people should have, such as California earthquake coverage, should not, by itself, be a reason for the government to reinsure or subsidize reinsurance.

3) **The best available underwriting data is largely or entirely in the hands of the public sector and cannot feasibly be released.**

The government gathers some types of data relating to war and terrorism that is not available to the private sector. The intelligence community, for example, almost certainly has the best data on the likelihood of terrorist attacks but, for reasons of national security, keeps it secret. This makes private sector underwriting harder or, perhaps, impossible in some cases.

Even passing all of these tests does not necessarily mean the government should provide reinsurance.

Most proposals for reinsurance to be provided by the federal government fail all of these tests. A few may pass one but only one existing program—terrorism insurance—appears as if might even possibly pass all of them all of them. Even this, however, does not mean that the current Terrorism Risk Insurance Act programs ought to continue in their current form or, indeed, must be continued as government programs. Simply that, in our judgment, they are justifiable.

<u>The Coordination of Reinsurance Supervision Nationally and Internationally.</u>

Reinsurance, quite arguably, is the most important economic activity that takes place *only* between businesses. By definition, no individual ever purchases reinsurance. Although information asymmetries are possible (as they are in any market), there is no reason to think that typical reinsurance "consumers" (large brokers and insurers) are any more or less sophisticated than reinsurers themselves. Thus, many forms of supervision (and coordination between supervisors) that are easy to justify in the national and international *insurance* markets are unwise in *reinsurance* markets.

As in insurance markets, the primary regulatory duty of the state is the same: to ensure solvency. The government, broadly, has a role in seeing to it that reinsurers can pay the claims they can reasonably expect to receive. Even so, the level of public resources that ought to be devoted to this is somewhat smaller than it is for insurance. Unlike individual and even business *insurance* consumers, the insurers and brokers that make reinsurance purchase decisions have the capacity to evaluate insurance themselves. Beyond this threshold, there are three areas in which governments nationally and internationally ought to coordinate supervision of reinsurance.

Assuring Free Flows of Capital

Reinsurance, as discussed above, works best when risks are pooled globally. No matter one's stance on free trade, it seems evidently obvious that it's better to spread downside risk as broadly as possible and that a wholly domestic reinsurance market is hugely undesirable. Thus, regulatory and tax measures that interfere with the free flows of reinsurance capital are particularly suspect and ought to be considered a threat to the reinsurance market globally.

In particular, taxes that have been proposed—specifically a bill that would place special taxes on offshore affiliated reinsurance ought to be seen as destructive to the reinsurance market. This is not only because they can be shown, decisively, to drive up insurance rates but also because they restrict the free flow of capital in global insurance markets.[9] But such taxes are simply an example: any measure that restricts the flow of capital in global reinsurance markets must be looked on with extreme suspicion.

Uniform State-Level Standard for Reinsurance (Particularly Collateral)

Efforts that promote consistent standards for treatment of reinsurance—particularly reinsurance collateral—allow for greater spreading and sharing of risk. The National Association of Insurance Commissioners has introduced solid new standards for reinsurance collateral make it easier for insurers to make use of capital from around the world by reducing the collateral requirements imposed on offshore reinsurers from competently regulated jurisdictions.[10] This is a sensible move that would expand coverage. While its actual power to do so is quite limited, the FIO should use its influence to encourage widespread adoption of these standards throughout the nation.

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[9] Micahel Cragg et al. "The Impact on the U.S. Insurance Market of H.R. 3424 on Offshore Affiliate Reinsurance: An Updated Economic Analysis," The Brattle Group, July 8, 2010, http://www.keepinsurancecompetitive.com/downloads/Brattle.pdf

[10] For an outline of the proposals see: National Association of Insurance Commissioners. "NAIC Adopts Revisions to Reinsurance Models," http://www.naic.org/Releases/2011_docs/naic_adopts_revisions_to_reinsurance_models.htm

Encouraging Growth in Capacity

When it comes to reinsurance, more is always better. Efforts that provide more capital tend to moderate the price of reinsurance and improve the overall function of the market. As such, all proposals to increase access to insurance capital deserve serious consideration. One proposal, forwarded by Rep. Eleanor Holmes-Norton, D-D.C., that would set up a special tax status for insurance reserves in the District of Columbia would have particularly positive consequences for the District of Columbia and deserves the FIO's strong and serious consideration.

Final Thoughts

Reinsurance plays a critical ongoing role in the property and casualty insurance economy of the United States. A thriving reinsurance sector that draws capital from all over the world is very much in the interests of America's consumers, their safety, and the nation's economy as a whole.

Respectfully Submitted,

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